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**NATHAN KAMINSKI, JR.**  
CHIEF OF STAFF

November 30, 2005

**To the Citizens, Governor and  
Members of the South  
Carolina General Assembly**

I am pleased to present to the citizens of South Carolina this Comprehensive Annual Financial Report for the State of South Carolina for the fiscal year ended June 30, 2005. The report provides financial information about the State's operations during the year and describes its financial position at the end of the year. For the convenience of users, we have divided the report into three sections as follows:

- The Introductory Section, containing this letter of transmittal; the Certificate of Achievement for Excellence in Financial Reporting that we recently received for our report as of June 30, 2004; a list of State officials; and an organizational chart of State government.
- The Financial Section, including the independent auditors' report, management's discussion and analysis, government-wide financial statements, fund financial statements, required supplementary information, other combining financial statements, and schedules.
- The Statistical Section, presenting comparative financial data and other non-financial data.

Management assumes full responsibility for the completeness and reliability of the information contained in this report, based upon a comprehensive framework of internal controls that was established for this purpose. Because the cost of internal controls should not exceed the anticipated benefits, the objective is to provide reasonable, rather than absolute, assurance that the financial statements are free of any material misstatements.

The State Auditor and Clifton Gunderson LLP, an independent certified public accounting firm, jointly performed an independent audit of the State's basic financial statements for the fiscal year ended June 30, 2005. The auditors have issued an unqualified opinion, the most favorable outcome of the audit process.

This letter of transmittal is designed to complement management's discussion and analysis that immediately follows the report of the independent auditors.

## **PROFILE OF THE GOVERNMENT**

South Carolina stretches from the Atlantic Ocean to the Blue Ridge Mountains, containing over 30,000 square miles. Fortieth in geographic area among the fifty states, South Carolina ranks twenty-fifth in population with approximately four million citizens.

As shown in the organizational chart on page 17, State government is divided into three separate branches: legislative, executive, and judicial. The State's citizens elect the legislative and executive branch officials. The General Assembly elects certain members of the judicial branch, including the Supreme Court. The principal State officials currently in office are listed on page 16.

State government provides a full range of services to South Carolina's citizens including educational, health, social/human, transportation, public safety, regulatory, and conservation/natural resources services. In addition, the State provides grants and loans to assist local governments, including school districts, within its borders.

Certain legally separate entities are included in these financial statements because they function, in essence, as part of State government. The Governor appoints the governing boards for the Public Service Authority, a public utility company, and the State Ports Authority. The Connector 2000 Association, Inc. assists the State's Department of Transportation on a toll road project. The Lottery Commission transfers its net proceeds to the State for educational programs. Other entities benefit and support institutions of higher education, provide medical malpractice insurance, and address medical and educational needs of South Carolina's children. Additional information on these legally separate entities can be found in the notes to the financial statements.

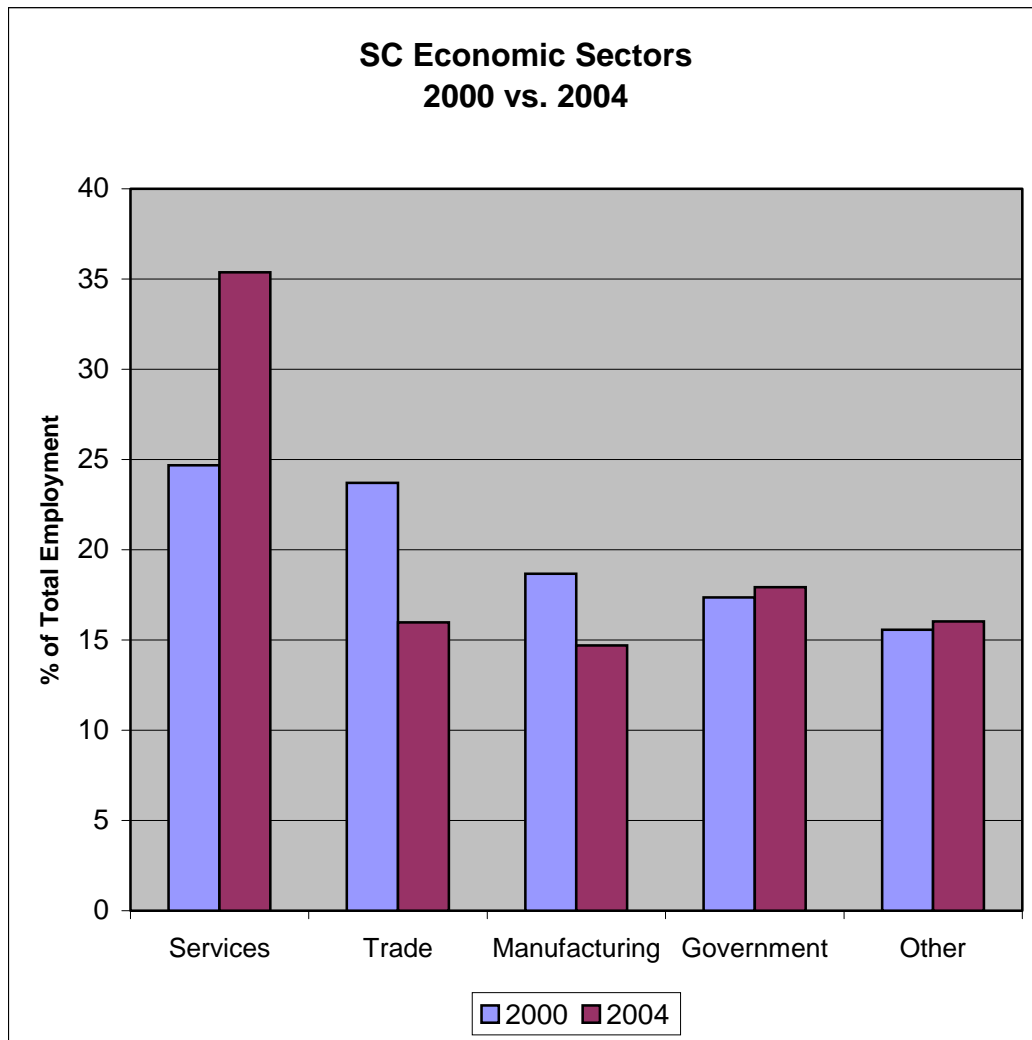
South Carolina's annual Appropriation Act includes legally adopted budgets for the Budgetary General Fund and for Total Funds. The initial budget appears in the annual Appropriation Act. After the budget year begins, the State Budget and Control Board, comprised of five key executive and legislative officials, may order spending cuts if revenue collections fail to reach predicted levels. Departments and agencies may request transfers of appropriations among programs if the transfer request does not exceed 20% of the program budget. The Budget and Control Board has the authority to approve additional transfers of appropriations between personal service and other operating expense accounts. For additional information, see the notes to the required supplementary information—budgetary.

## **LOCAL ECONOMY**

South Carolina historically has been a manufacturing state; however, the State's economic base has been transitioning toward other sectors such as trade, health care, services, and durable goods manufacturing. Businesses have migrated here from all over the world to take advantage of the State's skilled labor force, competitive wages, lower-priced land, excellent port facilities, accessibility to markets, and in recent years, substantial tax incentives.

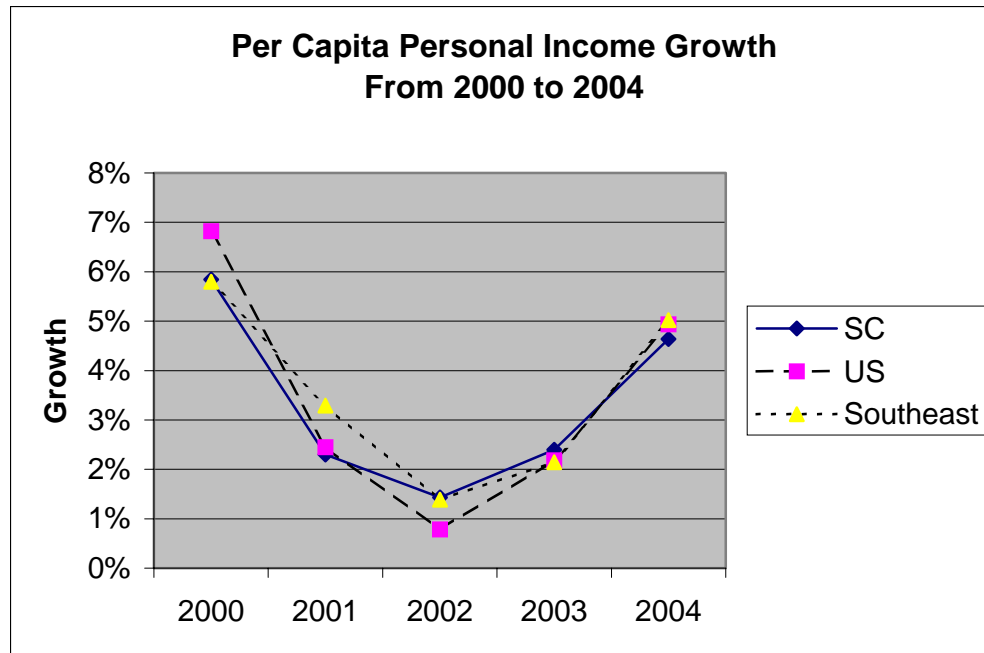
Employment in the State rose during 2004 by 1.1% over the prior year, matching the national pace. However, South Carolina's overall economy generally remained stable during the past five years (January 2000 through December 2004). While total employment levels remained largely unchanged during this period, the State's economy has become more diversified and is starting to move closer to the national base. Employment in the manufacturing sector has been declining such that manufacturing employment now represents less than 15% of total employment, down from about 19% in 2000. The State's service sector, fueled by tourism and retirement industries, has contributed to a more diversified overall employment base and improved income levels. This sector represented 35% of total employment in 2004, up from 25% in 2000. Similarly, the State's metropolitan areas are

enjoying rapid job growth while rural areas, traditionally supported by textile manufacturing jobs, are struggling.



The State's average unemployment rate has remained above that of the national level since 2001. South Carolina's unemployment rate was 6.8% for 2004, compared to the national average of 5.5%. While recent federal employment statistics indicate that the State's employment growth is slow, the State is reporting strong growth in personal and corporate income withholding taxes and in retail sales tax collections. This growth suggests that a more robust economy actually is occurring.

Average personal income growth for 2000 through 2004 was 4.5%; equal to the national average, but less than the 4.8% growth for the southeastern region. Despite this, the State's \$27,153 per capita personal income in 2004 represented only 82% of the national average and 91% of the southeastern average. In 2004, South Carolina ranked 43rd among states in personal income per capita, down from 39th in 2000.



Despite the State's fluctuating economic performance over the past few years, South Carolina's economic prospects are bright. The State is committed to improving its economic base and has been successful at attracting foreign investments, most notably in the automotive industry. Chemicals and metals, as well as specialty textiles, also have been consistent major components of capital investment in recent years. The State has undertaken several new economic development programs in the past few years with the goal of fostering growth, increasing economic diversity, and raising income levels. The State has authorized the issuance of economic and university research bonds to help attract new industries in fields such as biomedicine, transportation, and alternate fuels. Continued growth is expected in health care, leisure and hospitality, retail trade, certain manufacturing segments, and military defense.

Vought Aircraft Industries has announced plans to build a \$560 million aircraft components manufacturing center in North Charleston. The company is expected to hire 645 highly paid employees initially and is expected to spawn thousands of jobs during both the construction and the production phases from related distribution, storage, supply and real estate. BMW is currently undergoing a \$600 million expansion in South Carolina, and has started production on its new sports utility vehicle. In addition, BMW has announced plans to develop a new model similar to a minivan at its Upstate plant.

The State's budgetary results have improved dramatically during the last two years, leading to an increase in hiring and salaries within State government. This comes after substantial reductions in State government employment with only limited pay increases since the economic downturns in 2000 and 2001.

There are several large military installations in South Carolina. These installations overall were spared the brunt of the Federal government's recent military downsizing. The State actually will have a net gain in military jobs because of base realignments. Charleston is expected to see a relatively small loss of military-related jobs, while the Columbia region could see a net gain of nearly 2,000 military jobs that could lead to other job growth.

## LONG-TERM FINANCIAL PLANNING

During the 2005 legislative session, the General Assembly enacted a bill establishing a formal process for long-term financial planning. State entities receiving 1% or more of the total annual General Fund appropriations will be required to provide an estimate of general fund expenditures for the next three fiscal years. This data, in conjunction with the Board of Economic Advisors' (BEA) long-term revenue estimate, is to be compiled and updated annually by the State Budget Office. The three-year financial plan will assist the State to more strategically assess its future financial commitments. The plan must be provided to the State's Budget and Control Board, the Speaker of the House of Representatives, and the President Pro Tempore of the Senate during the second quarter of each fiscal year.

Principal financial challenges facing South Carolina, as well as other state governments, include future spending increases for Medicaid, retirement and health benefits, and both elementary and secondary education.

Medicaid spending for fiscal year 2004-2005 made up about 19% of the State General Fund budget as compared to 10% ten years ago. Medicaid is expected to consume more of the State's budget in the future due to a growing population accompanied by spiraling long-term health care and prescription drug costs. In an effort to contain these costs, the State's Department of Health and Human Services (HHS) has proposed an innovative plan to overhaul the Medicaid program. The HHS proposed plan seeks waivers for certain optional Medicaid funded activities and places most of the program's participants into managed care health insurance programs similar to those used by citizens with private insurance. In October 2005, HHS submitted its revised Medicaid plan to the federal government for approval. HHS estimates that the revised plan would save approximately \$300.000 million over the next five fiscal years.

As of July 1, 2004, the South Carolina's Retirement Systems had a combined actuarial value of assets of \$23.637 billion and a combined unfunded actuarial accrued liability of approximately \$5.579 billion. The State's actuarially determined pension liability was funded at 81% as of July 1, 2004, the date of the last actuarial valuation. This percentage is down from 98% as of July 1, 1999. As a result, the State's General Assembly passed pension legislation during the 2005 legislative session that increased the maximum amount allowed for equity investments from 40% to 70%; increased employee and employer retirement contributions over a two-year period by 0.5% and 1% respectively, and reduced certain retirement benefits.

Aid to school districts is expected to continue climbing in the coming years. The State is committed to improving the public education system by increasing teacher salaries and per pupil spending, enhancing teacher qualifications, raising standards for improved accountability, and purchasing school buses.

## RELEVANT FINANCIAL POLICIES

For South Carolina's government, fiscal year 2004-2005 was a time of financial recovery and restoration. During the 2005 session, the legislature enacted a bill that formalized a three-year financial planning process (described in the *Long-Term Financial Planning* section above) and provided for the full restoration of amounts transferred in prior years from certain trust and other budgeted funds. The bill also implemented procedures for maintaining positive fund balances for the State's General Fund when reported in accordance with generally accepted accounting principles (GAAP).

The State transferred monies from certain trust funds and other budgeted funds during 2002 and 2003 to finance recurring General Fund operations. The State is committed to paying back these

funds in several phases. A provision within the 2005-2006 Appropriation Act provides supplemental appropriations from the fiscal year 2004-2005 budgetary surplus funds to partially restore these accounts. Newly enacted legislation also requires that the first 10% of future surplus funds be applied to those accounts until fully restored.

Although the State historically budgets on a conservative basis, the economic downturn during 2000 and 2001, coupled with overly optimistic revenue projections, resulted in an accumulated budgetary deficit through the end of fiscal year 2002-2003. In addition, the State's GAAP-basis General Fund reported a fund balance deficit for four consecutive fiscal years (2000-2001 through 2003-2004). The accumulated budgetary deficit was resolved in the 2004 legislative session through the Fiscal Discipline Act. During the 2005 session, new legislation effective July 1, 2006, provides policies for maintaining a positive GAAP fund balance. This legislation calls for the suspension of both the Capital Reserve and any supplemental appropriations from budgetary surplus funds, if necessary, to offset a negative fund balance in the State's GAAP-basis General Fund.

## **MAJOR INITIATIVES**

### **Finance and Budgeting**

As noted in the above *Long-Term Financial Planning* and the *Relevant Financial Policies* sections above, several important actions have been taken to improve the State's financial condition. Other important legislation in the 2005-2006 Appropriation Act includes full funding of the Education Finance Act, which provides new monies to keep the State's teacher salaries above the southeastern average and additional funds for the State's elementary and secondary school programs. The 2005-2006 Appropriation Act also provides full funding for the State's Medicaid program; a 10% raise for the State's law enforcement personnel and a 4% raise for other State employees; and hiring additional law enforcement officers.

### **Business and Economic Development**

The General Assembly also approved the 2005 Jobs Creation Act that promotes and encourages small businesses to create new jobs. This legislation encourages investment in high-tech and start-up companies and creates the Capital Access Program to assist small businesses in obtaining financing.

A small business income tax reduction bill was passed that provides that the State income tax rate of 7% for small businesses be lowered by 0.5% per year for qualifying businesses until the rate reaches 5% in 2008.

Amendments to the Motion Picture Incentive Act also were passed that extend exemptions from sales and use tax for motion picture production companies to include exemptions from local sales and use tax as well. The amendments also included a rebate program for these companies to cover South Carolina payroll dollars.

### **Courts System**

The General Assembly passed two separate pieces of tort reform legislation. This legislation establishes new sanctions to control frivolous lawsuits, prohibits venue shopping whereby courts had been selected because of a reputation for making large rewards, and revises the liability provisions for a party that is only slightly at fault. The General Assembly also passed comprehensive Medical Malpractice Reform that places a \$350 thousand cap on non-economic damages such as pain and suffering, and provides legal protection for doctors who render care in emergency situations.

## **AWARDS AND ACKNOWLEDGMENTS**

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the State of South Carolina for its comprehensive annual financial report (CAFR) for the fiscal year ended June 30, 2004. This was the seventeenth consecutive year that the State of South Carolina has achieved this prestigious award. In order to be awarded a Certificate of Achievement, a government must publish an easily readable and efficiently organized CAFR. The report must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. We believe that our current CAFR continues to meet the Certificate of Achievement Program's requirements and we are submitting it to the GFOA to determine its eligibility for another certificate.

Production of this report was made possible only by the support of all State agencies and component units that supplied GAAP closing data on a timely basis. We extend special appreciation to Mr. Larry Pearce, Director of Publications and Printing at the University of South Carolina, for providing the report's attractive cover.

Sincerely,

A handwritten signature in black ink, appearing to read "Richard Eckstrom". The signature is fluid and cursive, with the first name "Richard" being more prominent than the last name "Eckstrom".

Richard Eckstrom  
Comptroller General